7 October 2010

The Availability and Use of Existing Laws and Programs to Improve Dairy Sector Economics

Dairy Industry Advisory Committee

U.S. Department of Agriculture

October 2010

Forward

The United States Department of Agriculture (USDA) established the Dairy Industry Advisory Committee in August 2009, under the rules of the Federal Advisory Committee Act (FACA). Agriculture Secretary Tom Vilsack announced the appointment of 17 members to serve on the Dairy Industry Advisory Committee on 6 January 2010.

As stated in its Charter, the purpose of the Committee is to review the issues of: 1) farm milk price volatility and 2) dairy farmer profitability. The Committee will also provide suggestions and ideas to the Secretary on how USDA can best address these issues to meet the dairy industry's needs.

This Committee is in the public's interest in view of the dairy industry's importance to the nation's economy. The exchange of views and information between industry representatives and USDA should result in improved

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understanding of the impact of USDA programs on the dairy industry and contribute to those programs' effective and efficient administration.

The members of the Committee are as follows. All members except Dr. Novakovic are considered under FACA to be serving as Representatives Members are appointed to obtain the points of view of or perspectives of outside interest groups or stakeholders for whom they represent. Dr. Novakovic serves as a Special Government Employee under appointment by Secretary Vilsack. An SGE is appointed to provide unbiased and independent advice. SGEs assume the responsibilities, obligations, and restrictions that are part of public service.

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Members	Affiliation	Committee Assignment
Paul Bourbeau	Paboco Farms, Inc., Vermont	Member
Jay Bryant	Maryland and Virginia Milk Producers Cooperative Association, Virginia	Subcommittee Chair - Volatility
Erick Coolidge	Le-MA-Ra Farm, Pennsylvania	Vice Chair Subcommittee Chair - Profitability
Timothy Den Dulk	Den Dulk Dairy Farm, LLC, Michigan	Member
Debora Erb	Springvale Farms & Landaff Creamery, LLC, New Hampshire	Member
James Goodman	Northwood Farm, Wisconsin	Member
James Krahn	Oregon Dairy Farmers Association, Oregon	Subcommittee Chair – Current Programs
Edward Maltby	Northeast Organic Dairy Producers Alliance, Massachusetts	Scribe
Rodney Nilsestuen (Dec. July 2010) replaced by Randy Romanski	Department of Agriculture, Trade and Consumer Protection, Wisconsin	Member
Andrew Novakovic	Cornell University, New York	Chair Chief Scribe
Robert Schupper	Giant Food Stores, Pennsylvania	Member
Manuel (Ray) Souza	Mel-Delin Dairy, California	Member
Patricia Stroup	Nestle USA, California	Scribe
Sue Taylor	Leprino Foods Company, Inc., Colorado	Scribe
Edward Welch	Associated Milk Producers Inc., Minnesota	Member
James (Ricky) Williams	Williams Dairy & Williams Dairy Trucking, Inc., Georgia	Member
Robert Wills	Cedar Grove Cheese Inc., Wisconsin	Member

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Executive Summary

In 2009 the dairy farmers suffered the joint effects of a cyclical downturn and the Great Recession, which affected them and other segments of the dairy sector. Congress has the authority to pass new legislation, but the ability of the federal government to respond to such events is limited to what is authorized under existing legislation. Some laws provide no leeway to the Secretary of Agriculture, others allow some or even considerable discretion. When a Secretary's proposed action has or is likely to have an impact on government expenditures, even "discretionary" programs cannot be used without approval of the President's Office of Management and Budget.

This report identifies existing laws that are under the purview of the Department of Agriculture and which could be used to the benefit of the dairy sector without new legislation. There are several programs that are explicitly designed for the dairy industry. There are quite a few that are more generic but which could be used to benefit dairy. In the latter, we have striven to be broad and comprehensive.

In the previous two years, the Secretary of Agriculture has invoked and leveraged a number of programs to assist dairy farmers through the market crisis. These include the following.

[insert excerpts from the USDA report of actions}

Barring legislative changes, the only two programs that permit the Secretary some flexibility in their application are the Dairy Product Price Support Program and one or more food assistance programs. If the

Secretary can identify sources of money, it would be possible for him to stimulate demand and thereby lift prices via either of these approaches.

The Secretary should use extreme care by applying both of these approaches judiciously and rarely and with sensitivity to the potential for commercial displacement of existing dairy product markets.

We suggest that USDA use the methodology of Milk Income over Feed Cost measure proposed by NMPF in its Foundation for the Future proposal as a trigger for implementation of both food assistance programs using dairy and any DPPSP increase. Within this framework, the first trigger will indicate a demand program be used. At the second trigger, the DPPSP should be invoked.

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Introduction

With the ink barely dry on the 2008 Farm Bill, the US economy plunged into what has been arguably the worst recession since the Great Depression of the 1930s. The impact on the dairy industry was a combination of recession-driven demand effects and more sector-specific supply effects. Dairy exports, which had been a primary cause of a prosperous lift in 2007 and 2008, collapsed as global demand withered. Domestic demand, especially in foodservice, declined as consumers trimmed household budgets. On the supply side, the costs of the single largest input into milk production – feed – hit record highs. This in turn created the worst price:cost squeeze since the early 1970s. While the industry was poised for a cyclical downturn in any event, the global economic downturn, in combination with record grain prices, pushed most dairy farm businesses into the red and eliminated years of growth in dairy farm balance sheets.

Although the Dairy Product Price Support Program eventually kicked in at the bottom of the price trough in early 2009, the level of support provided was fair less than required to ensure breakeven cash returns for dairy farm businesses. The Milk Income Loss Contract (MILC) program provided cash supplements to many farmers, but the marketings-based limit on payments meant that any farm larger than 110-150 cows, a little more than the national average, received a supplement on only a portion of their milk. This limitation applied to about 15 percent of the farms, which produce 75 percent of the nation's milk. For the 2.5 percent of the largest farms, which produce 47 percent of U.S. milk, the amount received was a tiny percentage of their total gross income. The negative economic effects

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during 2009 were no less for large farms, and arguably worse to the extent that they rely more heavily on purchased feeds.

Although the current net income situation for dairy farmers is much improved in 2010, the milk production sector has not restored its balance sheet and feels very vulnerable in the current uncertain economic environment.

The purpose of this report is to catalog the various laws and programs that presently exist to the economic benefit of dairy farmers and to discuss their potential application and limitations in the recent and current market environment.

The Dairy Challenge

Milk Price Volatility

Prior to the establishment of permanent authority for the Dairy Price Support Program under the Agricultural Act of 1949, farm milk prices exhibited a high degree of instability, but these fluctuations were primarily seasonal and generally predictable. From 1950 to 1989, milk price instability was considerably dampened compared to the first half of the twentieth century, in the range of half.[1] During the 1970s, the primary price

[1] The Coefficient of Variation – which measures dispersion or range adjusted by mean or average values, was 0.33 from 1942 to 1989 but only half that amount, 0.16, from 1990 to 2010. Volatility (as measured by the statistic historic volatility was twice as large in the recent period – 16.3% versus 7.9%. In other words, adjusting for inflation, the general range in which prices move is actually less now than in the years of an active price support program but the volatility of market prices is considerably larger.

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mover was inflation, which affected the entire U.S. economy. From 1981 to 1990, dairy economics was largely defined by huge surpluses engendered by an overly aggressive price support policy in the late 1970s, followed by a variety of policy interventions aimed at minimizing the need of reductions in the price of milk. In response to these supply surpluses, the support price for milk was reduced from over $13.00 per hundredweight (cwt) to around $10.00 per cwt., where it has remained. This level of support has proved to be sufficiently low so as to seldom interfere with the market-determined price for milk.

Since 1990, the farm milk price has become highly variable and unpredictable. This combination of instability and uncertainty may be described as price volatility.[2] The causes of this increased volatility are

[2] To describe different aspects of pricing concerns, Andrew Novakovic of Cornell University differentiates three fundamental characteristics of a price series – 1) certainty/uncertainty, 2) stability/instability, and 3) adequacy/inadequacy.

Certainty might be defined as existing when a price can be predicted within a narrow range over an intermediate term. Dr. Novakovic does not propose a specific measure, but an example of certainty might be a monthly price that can be predicted within 5% over a one year period.

A currently stable price is not necessarily predictable in the future, and unstable prices are not necessarily unpredictable. A familiar dairy example would be the highly predictable seasonal patterns in milk prices common in the 20th Century.

Instability implies a frequency of change more than an amount of change (amplitude), thus, standard deviation or similar measures of dispersion are not reliable measures of standard deviation. Log relative volatility or historic volatility, statistics used primarily in the finance literature, are better measures of instability.

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debatable. The reduction of the federal support price for milk seems to have revealed an underlying volatility or susceptibility to volatility. Dairy analysts have long described dairy markets as having highly inelastic supply of and demand for farm level milk, and demands for dairy products down the value chain. While the degree of elasticity is sometimes debated, most industry members would agree that the short term elasticities are indeed small. As such, small relative changes in quantities are associated with large relative changes in price. This would certainly be consistent with the post 1990 experience.

During the inflationary period that began in about 1972, unusually large annual increases in price were generally associated with modest levels of domestic surplus. However, these modest surpluses burgeoned into oppressively large surpluses by the early 1980s. During that decade, prices drifted downward as the federal government made repeated and bold efforts

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Adequacy refers to the degree to which a price is associated with positive financial outcomes for a business whose output receives that price. A number of measures might plausibly appeal to a business owner's concept of adequacy. Certainly profitability would be a desirable long term measure. However, other measures might also be applied, including return on assets, return on equity, return on investment, net returns over cash cost or cash flow from operations, cash flow coverage, and so on. A number of policy advocates have endorsed net returns from the sale of milk in excess of the cost of feed as a convenient and meaningful measure of adequacy.

The term volatility has been much used in the recent economic context and seems intended to convey something more or different from instability. Dr. Novakovic's proposed nomenclature uses the term volatility to describe a price that is characterized by both instability and uncertainty and is inadequate at its lower points.

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to avoid or reduce price cuts through a variety of supply controlling and demand enhancing actions. Ultimately, a 25 percent cut in the support price occurred before markets settled into equilibrium.

The first few years following the decline of the Dairy Price Support Program witnessed the kind of turbulence that has now become familiar, but these were interspersed with a few calmer years as well. The next significant policy event that seems have changed dairy markets was the conclusion of the Uruguay Round negotiations under the General Agreement on Tariffs and Trade, now know by the acronym WTO, for the new secretariat created after the Uruguay Round – the World Trade Organization. In the U.S., the Uruguay Round Agreements Act was passed in 1994. Under the Agreement on Agriculture (AoA), the United States agreed to increase the access to its dairy markets by foreign competitors (from about 2.5 percent to five percent) and replaced its strict import quota system with a tariff-based system that generally provided a high degree of protection from most dairy commodities and greater access to value added products (such as European-style cheeses).

Costs of Production

In addition to the large swings in the price of milk, dairy farmers have recently experienced significant changes in underlying costs of production, driven by dramatic changes in the prices of certain key inputs. The single largest component (40-50%) of any dairy farmer's cost of production is the cost of feed, whether it is in the form of purchased grains and other feed inputs or as the costs of producing homegrown feeds. Thus, dairy farmers

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are especially sensitive to the prices of purchased feeds or the prices of inputs used in homegrown feed production. Key feedstuffs are corn, soybeans and alfalfa hay. Key production inputs are fuel, fertilizer and seed.

From Fall 2006 through Summer 2008, the price that growers received for a bushel of corn increased from about $2.00 to about $5.50. While this is welcome news for corn growers, it represented an enormous cost increase for dairy and other livestock farmers. The increase in soybean prices was equally dramatic. Although it would be a bit too simplistic to attribute all of this effect to the burgeoning demand for ethanol made from corn, it is likely that bio-fuels created a large and new demand for corn and, because of acreage competition, soybeans and other feedstuffs. Petroleum prices began increasing out of their previous historic range in 2002. The stimulus of high petroleum prices, increasing uncertainty about the reliability of Middle Eastern sources of petroleum, and successful efforts to create various federal incentives for corn-based ethanol contributed to pushing corn prices to dramatic heights in 2007 and 2008.

Milk prices had hit a cyclical low in 2006. An expected cyclical rebound, exaggerated by the added impact of high feed costs that decreased milk supply, moved the price of milk from a low of $11.70 per cwt in July 2006 to a high of $21.90 in November 2007 – the all time record high for the nominal price of milk. In the early months of 2007, the rise in the price of milk did not keep pace with increases in feed costs. Farmers experienced the curious but not unprecedented phenomenon of relatively high milk prices but poor net returns. By the peak of the market, farm returns were more

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than enough to compensate for high feed prices and net returns were generous.

By the end of 2008 and through 2009, the equation had again turned against dairy farmers. Although corn prices and other input prices had softened considerably from their previous highs, largely due to record crop production, milk prices had fallen even more. The hard lesson of 2009 was not so much the low price of milk, which after all was no lower than the bottoms of the last two three-year cycles, but the unprecedented low to negative margins. In many months, there was little if any left over from the milk check to pay for more than the cost of feed. This is illustrated in Figure 2. This figure compares indices of the US price of all milk with USDA's index of production inputs purchased by a weighted average of livestock production. Dairy is only one part of this livestock index, but it is a sufficient measure to illustrate the dramatically poor relationship between feed weighted input prices and the price of milk. This chart illustrates vividly that the dramatic outcome of 2009 was not how low the price of milk became, per se, but rather the narrowness between the price of milk and the costs of inputs, especially feed inputs.

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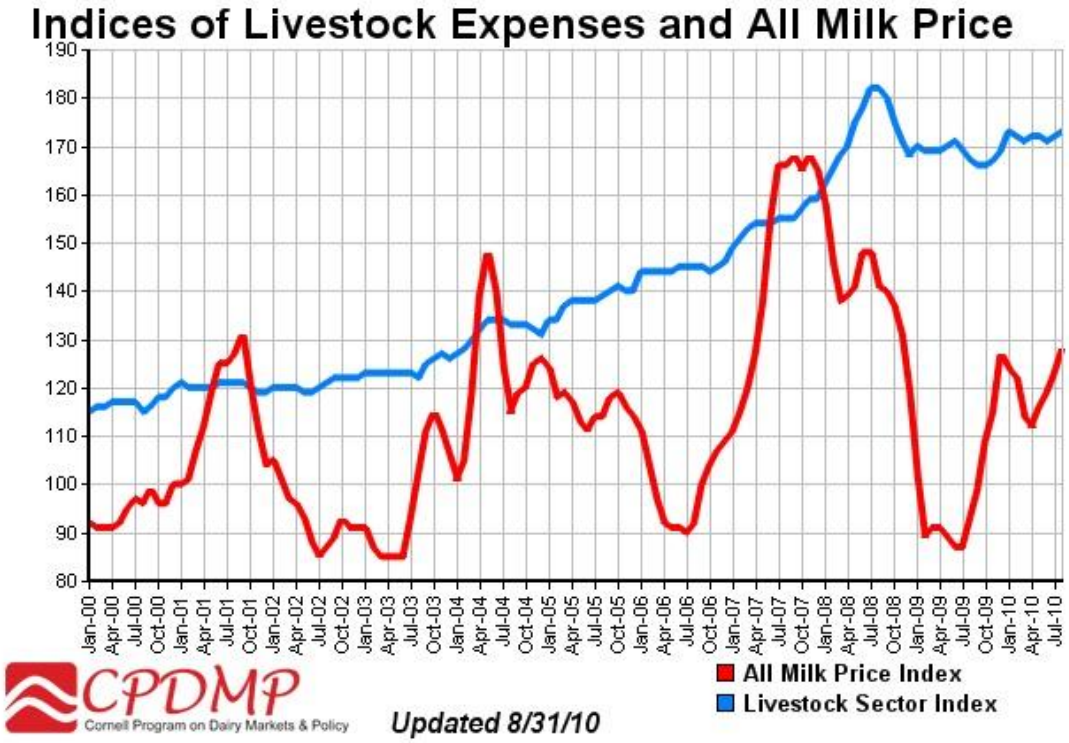

The previous chart shows prices. In the next chart, these prices are translated to returns to milk above feed costs, using the methodology developed by the National Milk Producers Federation, as described in their proposal called Foundation for the Future. Although milk prices (in the above chart are equally low in 2003-04, 2006, and 2009, in this next chart it is vividly clear that the net returns to milk above the feed index costs of the major feeds is dramatically lower in 2009.

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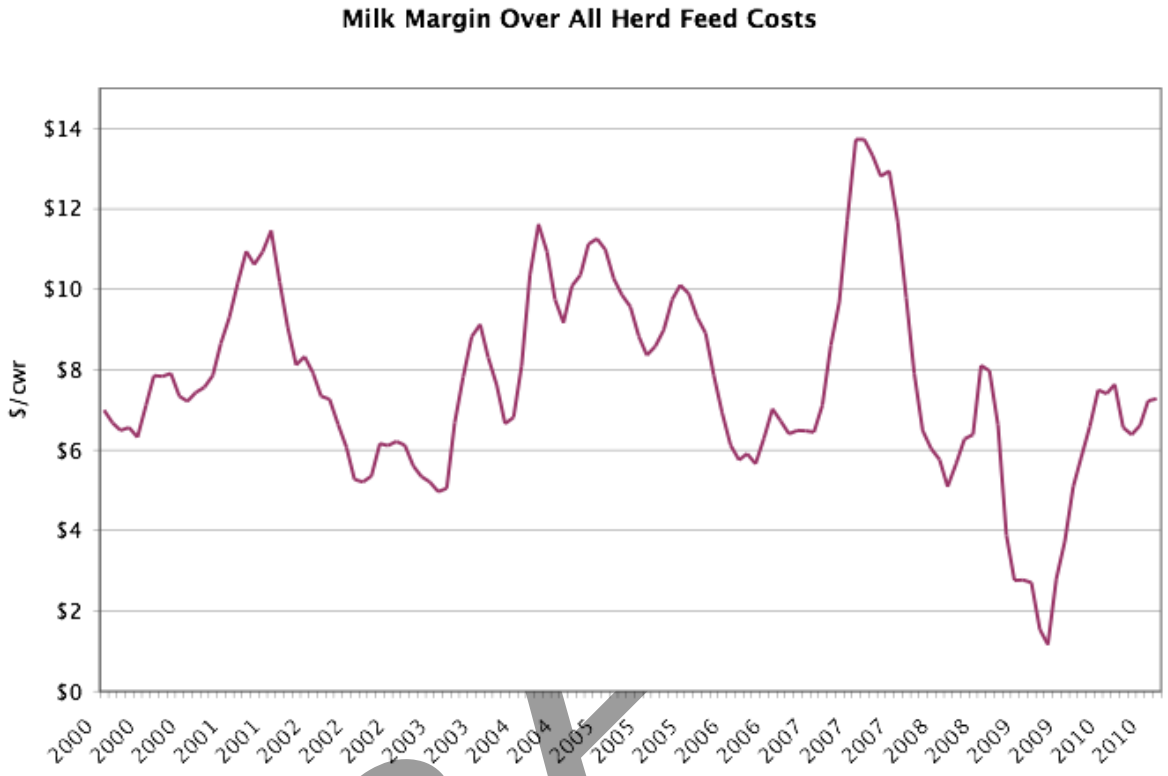

Dairy farmers are rational managers of their business. When prices of inputs change significantly, they make adjustments to their input usage. Of course, those adjustments have implications for current and/or future production, and they must balance those effects. Although the term "cost" is often used as a synonym for the price paid for an input, as in "the cost of corn", there is an important distinction between costs and prices, a distinction that is important in both economics and accounting. Prices, of course, are what a buyer pays to purchase one unit of a good. It is denominated in dollars per unit of input purchased, such as dollars per bushel of corn ($/bu). Total costs are measured in total dollars and measure the amount of money spent to acquire a volume of an input, like corn.

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Average cost can be expressed relative to the amount of milk produced. Thus, the average cost of corn for a farmer in, say, 2009, can be expressed in dollars per hundred pounds of milk sold ($/cwt). Average cost (or more simply "cost", to which it is often shortened) is not the same as price. The key difference is that average cost is affected by how much input is purchased (which determines total cost along with the price of the input) and how much product is sold (which determines the average). A margin also reflects the quantity sides of revenue and expenses, as well as the input and output prices. When an average cost line looks similar to a price line, this is an indication that quantities of inputs and outputs don't change much relative to price changes. This is often the case in agricultural production. If one compares the last two charts carefully, it is clear that the low point in Milk Margin over Feed Costs ($/cwt) during 2009 is far lower (about one-third) compared to the previous troughs in 2006 and 2003. Although farmers adjusted their purchases of inputs in response to the price:cost squeeze, there is only so much one can do before the implication for production or the health of the cow does not justify further reductions in the use of an expensive input. Moreover, although there are a variety of feedstuffs available to farmers, there are only so many feed inputs one can use in a balanced ration. Moreover, the prices of all feeds tend to move in the same direction.

Price and margin are certainly correlated, but they are not the same thing. One might say that "prices" are a cause and "costs" or "margins" are an effect – financial outcomes that are impacted or changed by prices. The critical importance of this simple fact of economics and accounting was made

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vividly clear in 2009 and continues to be in evidence and of concern in 2010. As will be further discussed elsewhere, it is valuable to note that most dairy and other agricultural support programs are based on or triggered by an output price. The usefulness of that simple approach, which seemed to work satisfactorily in the past, has been seriously challenged by the events of the last two years.

Trade Shocks

As mentioned above, the US dairy sector became considerably more exposed to trade following the Uruguay Round agreement. This resulted in both greater opportunities for exporting, as well as greater openness to imports. In the years that have followed the URAA, the US dairy sector has generally become a slight net importer of dairy products; however, it has demonstrated a capacity to increase exports considerably when conditions are right. Such was precisely the case in 2007 and 2008, as illustrated in the next chart.[3]

[3] Dairy trade can be measured in several ways. For individual products, quantity measures are fairly straightforward. For aggregations of products, the typicaly approach is to translate product pounds into a milk equivalent. While this seems easy enough in principle, in practice it becomes challenging because traded products have very different compositions of milkfat and nonfat solids. An alternative is to measure trade in dollar value. This has a certain appeal and finesses the problem of milk equivalents, but it introduces other consequences. Because the US tends to be an importer of high margin products and an exporter of low margin products, dollar measures tend to give greater weight to imports than quantity measures.

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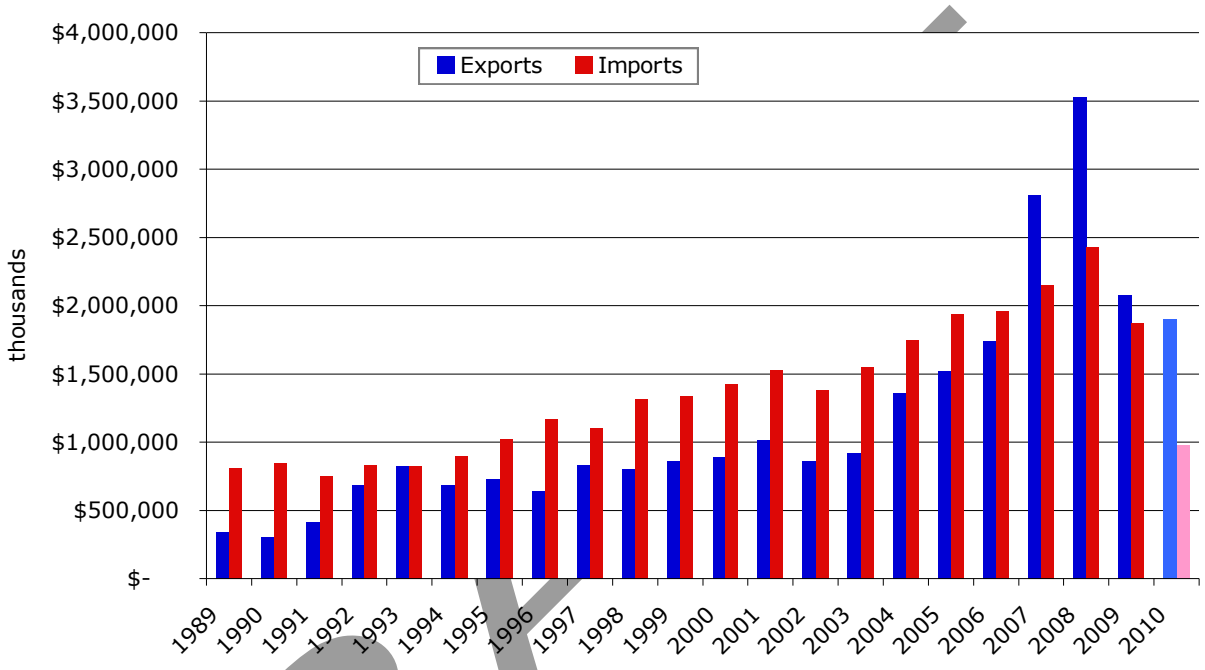
Total Dollar Value of US Dairy Imports and Exports,
1989 to July 2010



Current Legislative and Regulatory Authorities

What is generally referred to as dairy policy or dairy programs are legal authorizations or mandates specified by Congress and implemented as regulations by the US Department of Agriculture or another executive agency of the federal government. Some of these programs exist under permanent law, in which the provisions have no sunset until Congress explicitly changes them. Others are of a more temporary nature. They may exist for many years, but periodically Congress needs to reaffirm them.

In addition, Congress has a good deal of latitude in how strongly it directs an action of the Executive Branch. In many cases, a law authorizes

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USDA or another agency to do something, but it does not require or even enable that action. For example, under the old parity-based Dairy Price Support Program, the Secretary of Agriculture could announce a support price for milk that was no less than 75% of the parity price but no more than 90%. Thus, he was authorized or allowed to choose within a broad range. Sometimes, the Secretary is allowed to decide whether to do something at all. For example, the Secretary is not required to implement a Federal Milk Marketing Order either by the instruction of Congress or at the request of farmers. The Secretary has the authority to deny a request for a new Order (although such a decision could be challenged by a court action). Lastly, the Secretary may be authorized to do something, and it may in fact be something that Congress or the Secretary would really like to do, but Congress or the Executive did not provide for funding. An example of this would be the authorization in the 2008 Farm Bill that USDA initiate electronic reports of market dairy prices based on prices that firms would be required to disclose to USDA. Congress did not provide specific funding for this costly project and USDA determined it lacked the flexibility to reassign existing general funding to support this new activity.

In this section, we describe current programs which could be used to have direct effects on milk prices, dairy product sales, farm incomes, or some other direct aspect of dairy markets. Needless to say, there are a huge number of federal programs that affect dairy markets, including tax policy, public borrowing, transportation, fuel taxes, environmental regulations and other such items that have implications for the dairy sector but which are not dairy programs per se. The focus here will be on

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programs that target dairy programs or which could impact dairy markets without requiring a focus on dairy from a program whose purpose is much broader.

The Dairy Product Price Support Program

Summary of Dairy Product Price Support Program (DPPSP)

Objectives:

- Price Support - prevent farm price of milk from falling below a minimum target level
  - Farm price stability
  - Farm income enhancement
- Market security
- Prevent wholesale price of selected dairy commodities from falling below a minimum target level
  - Price stability for selected dairy commodities
- Maximal effect on protecting against price decreases, minimal effect on inhibiting price increases
- Minimize impact on commercial sales when disposing of government stocks

Methods:

- Under Dairy Price Support Program (DPSP) -
  - Law establishes a price support goal (minimum) for milk used to make manufactured dairy products. USDA estimates purchase prices for selected dairy commodities in bulk form that are consistent with that goal.
- Under the Dairy Product Price Support Program (DPPSP) -
  - Law establishes purchase prices
- Under both DPSP and DPPSP -
  - USDA/CCC offers to purchase butter, cheese, and nonfat dry milk, according to established specifications, at the announced purchase prices.
  - If this price is appealing to manufacturers of those commodities, compared to prevailing or expected market prices, the manufacturer initiates a "response" to USDA's "invitation.
  - CCC takes ownership of the product and is expected to dispose of the product in a manner that recognizes its value as a food product but which does not undermine the commercial market for similar products. This may included domestic and international food assistance, use in government programs and facilities, use in animal feeds, and the like.
  - If a product is offered for sale in commercial channels, it is at a price no lower than the established Sellback Price. Before 2008, the Sellback Prices were set by the Secretary and varied from 105% to 110% of the corresponding Purchase Price. Under FCEA 2008, the Sellback Prices are legislatively established at 110%

Summary of Dairy Product Price Support Program (DPPSP)
Legal Authority: Agricultural Act of 1949 (as amended)
Administering Agency: U.S. Department of Agriculture - Farm Services Agency Farm Programs - Price Support Division Commodity Operations - Commodity Credit Corporation

Following the World War II, at a time when price inflation was high but agricultural cost inflation exceeded output price inflation, Congress passed the Agricultural Act of 1949. This Act created permanent authority for a Dairy Price Support Program, under which Congress specified goals for the minimum support of the price of milk received by farmers and USDA implemented that goal by offering to buy selected bulk dairy commodities at wholesale prices that were consistent with the farm price goal. This Act provided permanent authority for the Secretary to support prices in a manner similar to that used during the War. This was a mandatory program. As such, Congress obliged itself to design a program that lived within their self-imposed budgetary rules, but, once passed, the Secretary was required to implement it without regard to cost.

In 1981, Congress suspended the authority of the Secretary to establish a support price for milk within the 75-90 percent parity range and instead set a specific, discrete support price for milk over which the Secretary had no latitude to change. This suspension was not permanent, but it was renewed in each successive Farm Bill until 2008, when the language of the legislation was changed away from specifying a support price for milk to establishing purchase prices for bulk, commodity cheddar cheese, butter and

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nonfat dry milk. This altered program was labeled the Dairy Product Price Support Program or DPPSP (as opposed to previous DPSP). In practice, this was a subtle change, as USDA achieved the support price for milk by establishing purchase prices for these same products. Under both versions, USDA offers to buy these dairy commodities at the announced prices under the belief that if market prices drop to or below these levels, manufacturers will begin offering eligible commodities to the USDA, instead of private buyers. USDA is obliged to buy any and all quantities of eligible products so offered. Insofar as manufacturers take advantage of this guaranteed price outlet, market prices should not fall below this government offer price, or at least not by very much.

The levels of the various supported prices before and after the passage of the 2008 Farm Bill are listed in the following table.

Price	Before FCEA 08	After FCEA 08
Support Price for Milk Used in Manufacturing, average fat test	$9.90	not specified
Purchase Price for Cheddar Cheese, blocks	$1.1314	$1.13
Purchase Price for Cheddar Cheese, barrels	$1.1014	$1.10
Purchase Price for Butter	$1.05	$1.05
Purchase Price for Nonfat Dry Milk	$0.80	$0.80

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Although Congress specified a fixed support price for milk from 1981 to 2008, when it passed the Food, Conservation, and Energy Act of 2008 it changed specifications of commodity support prices from "shall be" to "shall be no less than." In so doing, it created the authority for the Secretary of Agriculture to announce higher purchase prices than those specified in the Act. This is the first time since the early 1970s that the Secretary has had discretion on the level of support for the price of milk.

It was under this new authority that Secretary Thomas Vilsack increased the purchase prices for cheese and nonfat dry milk from August to October 2009. Compared to the purchase prices listed in the table above, the Secretary increased the purchase price of cheeses by 18 cents per pound (16%) and nonfat dry milk by 10 cents per pound (15%). This equated to about a $1.50 to $1.80 increase in the implicit support to the farm price of milk for those three months. This action resulted in few sales to the CCC, as market prices increased over the same period.

In November, prices reverted to the levels specified in the FCEA 2008. Many in the dairy producer community have asked why the Secretary did not exercise that authority in early 2009 or even late 2008, when prices were falling to their nadir, or why he did not extend assistance longer.

The answer to these questions lies in large part with the situation described earlier in this report, where authority is differentiated from budgetary ability. Although the FCEA 2008 does in deed provide authority to the Secretary, this authority is ineffective if there are insufficient funds to back up the implied obligation. When passing a bill, the Congressional

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Budget Office, using budgetary guidelines created by Congress itself, determines if Congress can afford to pass a bill that has budgetary implications. Once a bill is in place, if it involves some discretionary action or decisions by the Secretary, then the President's Office of Management and Budget has the authority to decide if the Executive Branch can afford it. Although the institutions are different, the process is very similar. Typically, the Secretary would be asked to come up with the money for a costly decision he would like to make. He is unlikely to be able to take money from one program to fund something in another program. For the same kind of reason, OMB is not likely to ask some other agency in the Executive to finance a program in Agriculture. The net result is that a decision to increase the support price to any level that is actually meaningful, i.e., USDA would actually incur an expense, is stopped before it can get started.

Milk Income Loss Contract

Summary of the Milk Income Loss Contract (MILC)
Objectives: Income Support - augment dairy farmer income when milk prices are low
Methods: Provide a countercyclical payment to qualified dairy farmers when the Class I price announced for the Boston city zone of the Northeast Federal Milk Marketing Order falls below a legislatively specified value. In addition to setting the benchmark or target price, the law also specifies a percentage of the difference between the between the target price and the announced price. The payment rate is based on that percentage. Total payments are limited to an amount of milk marketings (pounds of milk). In each marketing year, qualified dairy farmers must elect the month in which they are first eligible to begin receiving a monthly MILC supplement. Payments are made in each consecutive month in which a payment is due until the limit on marketings is reached, regardless of the dollar amount of the payment.

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Summary of the Milk Income Loss Contract (MILC)
Legal Authority: Food, Conservation and Energy Act of 2008 (FCEA). Legislative origin traces to emergency market transition assistance authorized under the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2000 (H.R.1906). The MILC was first formally authorized as such under the Farm Security Act Act of 2002 (FSA).
Administering Agency: U.S. Department of Agriculture - Farm Services Agency Farm Programs - Price Support Division

The Milk Income Loss Contract is a form of countercyclical income support that was devised with some elements drawing from the structure of the one-time Northeast Dairy Compact and the countercyclical price subsidies established for program crops (food and feed grains, etc) in the Farm Security Act of 2002.

The Northeast Dairy Compact was a Congressionally sanctioned agreement between the six New England states to coordinate a minimum price for Class I milk marketed in their jurisdiction. The Compact granted authority to set a minimum Class I price of $16.94 per cwt. that all buyers of Class I milk were required to pay, either as a premium above the federally regulated Class I price or as a price established for any federally unregulated handler. Inasmuch as this price premium applied only to Class I milk, the total money collected in any given month was pooled and shared pro rata among all farmers in New England or delivering milk to a New England bottler. The minimum Class I price was announced relative to the the Boston city zone of what was then Federal Order 1, the New England Order.

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When Congressional approval for this multi-state Compact expired, the calculation methodology was adapted to a countercyclical income subsidy that would apply to all dairy farmers in the contiguous United States. The Boston city zone price of $16.94 was established as the price trigger. A payment rate was determined as 40 percent of the difference between the announced monthly price and the trigger, approximately the same percentage as the U.S. Class I utilization. In addition, a payment limit was established based on the pounds of milk marketed by a farm entity. The quantitative limit represents a type of payment limitation that has two objectives. It limits government exposure to budget costs. Furthermore, it targets benefits towards smaller scale farmers, achieving a general policy objective that has had broad support in Congress. In this framework, the actual expenditures depend on the magnitude of the payment rate as well as the marketings payment limit. An individual farm can achieve the maximum payment limit with a very small subsidy or a very large subsidy depending on the payment rate for any given month. Inasmuch as many farms market more milk in a year than the annual payment limit, farmers are allowed to choose the month within a marketing year in which they wish to be eligible to receive a payment. Payment will begin in that month or the first month thereafter in which a payment rate is announced and continue until the marketing payment limit is reached. The marketing year begins in October, and the payment limit resets to zero at that time.

In 2008, Congress also modified the trigger price to include an automatic adjustment for changes in the prices farmers pay for certain feeds used in a dairy ration. The national dairy ration cost is routinely calculated

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by USDA's National Agricultural Statistics Service. The automatic adjustment is triggered when the monthly ration costs exceeds $7.35 per cwt but the trigger price is increased by 45% of the relative difference between the ration cost trigger and the estimated actual cost. For example, if the dairy ration cost is estimated to be 10% above $7.35, the milk payment trigger rises 4.5% (or $16.94 times 1.045 = $17.70)

The program is administered by the Farm Service Agency of the U.S. Department of Agriculture and is a mandatory program over which USDA has no discretionary authority. USDA does promulgate rules to interpret and enforce the program as authorized by Congress. These rules define requirements for eligibility and compliance, and the like, but they do not alter the fundamental parameters specified in legislation.

Federal Milk Marketing Orders

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Summary of Federal Milk Marketing Orders (FMMO or FO)
Objectives: Create market conditions that will encourage: Orderly marketing activity; markets that function smoothly, predictably, and at a reasonable cost Orderly pricing (predictable but not necessarily stable or adequate) Adequate and wholesome supplies of fluid milk Equitable returns to farmers, equitable prices for processors
Methods: Regulate and supervise the terms of trade between farmers and processors, by setting minimum farm level prices and trading rules that determine who qualifies for what price, so as to create market (price) incentives that result in desired market behavior or performance The fundamental and legislatively mandated tools are: Classification of producer milk according to the product in which it is used Pricing of milk according to class Pooling the values paid by processors for each class of milk to return a common "pool" price to all producers, regardless of the actual destination of their milk Auditing to ensure and enforce compliance by regulated handlers
Legal Authority: Agricultural Marketing Agreement Act of 1937 (as amended)
Administering Agency: U.S. Department of Agriculture - Agricultural Marketing Service - Dairy Programs

Federal Milk Marketing Orders are the oldest of dairy industry specific programs. The concept of using classified pricing and pooling was originally developed by milk marketing cooperatives operating in the New England area during the late 1800s. The concept was predicated on the notion that milk used for fluid or beverage purposes has a different economic value than milk used for manufacturing, but that Grade A milk can be used in any of a number of products. To ensure that all producers of Grade A milk received a

fair and equitable return, all year around, cooperatives developed this method for establishing prices of milk based on its use (classified pricing) and sharing the average value of milk in all uses to all Grade A farmers (pooling). The latter was established in particular to eliminate destructive competition among farmers who would otherwise have incentives to seek the highest class price and thereby ensure that farm milk was transported in a manner consistent with minimizing marketing costs.

This general concept was adopted under both federal and state laws beginning in the 1930s, as elected officials sought methods to bring price relief to dairy farmers during the Great Depression. Over time, most state laws gave way to the federal law due to their inability to price milk in interstate trade and for regulatory efficiency. However, there remain several states that continue to have some form of milk price regulation. These state orders typically use a form of classified pricing and pooling very similar to a federal order, but they may also involve a simple price premium that is applied to FMMO prices that pertain to regulated handlers in their state. These states are California, New York, Pennsylvania, Virginia, Maine, Montana, Nevada, North Dakota. In only CA, NV and ND are all state based processors regulated by the State.

The concept of an Order is predicated on the assumption that the marketing of milk is inherently regional and subject to a geographic description and boundary. The marketing area is defined by the area in which a group of fluid milk processors routinely compete for the sale of packaged milk. It is not expected that this is an impermeable boundary, but

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the size of a marketing area may be smaller or larger as nature of competition among fluid milk processors dictates. Understandably, marketing areas have become larger and larger over time. Consequently, FMMO areas have evolved from city-sized areas to large areas spanning several states. Fluid milk processors are automatically subject tot he requirements of a FMMO. Manufacturers of other dairy products are not automatically regulated. Instead, manufacturers are required to demonstrate that in some fashion they are part of a coordinate supply of milk that benefits the fluid milk market, especially in times of year when the supply of milk is short relative to the demand for Class I milk. The specific performance or pool qualification requirements vary to some extent across Orders, to meet conditions of each area, but the general concept is the same everywhere. Once the set of plants that are subject to the regulation of an Order is determined, the each regulated handler is obliged to pay a minimum class price for milk based on how the handler uses the milk it purchases. Although handlers tend to be specialized, the price(s) they owe are based on how each pound they purchase is used. A plant may predominantly process Class I milk or Class III milk, but a plant is not a Class I plant *per se*, so much as it is a plant that uses milk in Class III products.

The basic idea of Federal Orders is fairly simple, but the actual implementation is quite complex. Anyone interested in more specific details of their operation is referred to the resources available from the US Department of Agriculture. Only two additional observations are highlighted here.

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First, Federal Orders are allowed under the AMAA of 1937, they are not mandated or required. Thus, the Act authorizes the Secretary to establish a FMMO subject to a request from producers in a marketing area and a subsequent formal hearing to determine the need for an Order and some specific requirements or characteristics of the marketing area. Upon review of the evidence presented in the formal hearing, and only that evidence, the Secretary may recommend a specific set of regulations for the farmers and buyers in that area. This set of regulations is called the Order. Farmers who would be regulated under the Order, and only they, have the privilege of voting for or against the Order proposed by the Secretary; however, the must vote for the Order in its entirety. They are not allowed to only pick the parts they like. The AMAA of 1937 requires the Secretary to craft Orders that are "in the public interest". As such, the Secretary has to balance the legitimate need and concerns of farmers, processors, and consumers. In so doing, s/he may choose some provisions that are not particularly favored by dairy farmers. Thus, the exclusive privilege farmers have to vote for a Federal Order is balanced by the "all or nothing" condition of the vote. An Order is approved if two-thirds of the dairy farmers who prices would be subject to the Order vote in favor of it. If their milk marketing cooperative allows it, a Cooperative may cast a "bloc vote" on behalf of all their farmers. The conditions framing any limitations on a bloc vote are determined by farmers as members of the cooperative.

Because Federal Orders are voluntary, it took quite some time to develop the system of Federal and State Orders that envelop the US today. Although first authorized in 1937, Federal Orders did not cover more than

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half of the US milk supply until the mid-1960s. Today, marketing orders cover about two-thirds of the US milk supply. California alone regulates over 20% of the US milk supply. The majority of the remaining 10-15% is regulated by other States (cf. above). The largest amount of milk not regulated by the USDA or a State is in Idaho. This may amount to about 5% of the US milk supply.

The second major highlight is that the process for changing a Federal Order is as formal and complex as the process for promulgating or starting one. Both processes are made by request or petition to USDA. A request to amend an Order may be approved or denied. If approved, the apparatus of formal rule-making applies. This requires that a formal announcement be made, which defines the scope of the hearing. A formal hearing is held. USDA make a recommendation based on the evidence of the hearing and the strictures of the AMAA. A majority of farmers who would be regulated under an amended order must approve the recommended order in its entirety. Under new rules established under the FCEA, the process for amending an order may be completed in as little as about 12 months; however, it remains the case that all changes to a federal order must follow the requirements of formal rulemaking and no matter how broad producer support for a change might be, USDA must balance all interests, including the public interest, when it makes a recommendation for a change.

While the Federal Orders have many functions in the dairy industry, the underlying structure, as well as the rulemaking required, means that the Federal Order system is not a viable vehicle for economic assistance for dairy farmers.

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Dairy Export Incentive Program

Summary of the Dairy Export Incentive Program (DEIP)
Objectives: Increase sales of US dairy products in foreign market, particular to countervail export subsidies from other suppliers (e.g., the EU) Encourage dairy product marketers to develop export sales
Methods: Provide "bonuses" or cash subsidies to dairy product exporters by supplementing privately negotiated export prices. When DEIP authorizations are announced, USDA establishes a quantitative target for export sales and invites private sellers to negotiate an export sale at the best price they can obtain, then apply for a price subsidy.
Legal Authority: Created under the Dairy Production Stabilization Act of 1983 and initiated in May 1985, Reauthorized under the Agriculture, Conservation, and Trade Act of 1990, the Uruguay Round Agreements Act of 1995, and the Federal Agriculture Improvement and Reform Act of 1996
Administering Agency: U.S. Department of Agriculture - Foreign Agricultural Service

(http://www.fas.usda.gov/exportprograms.asp)

The Dairy Export Incentive Program (DEIP) helps exporters of U.S. dairy products make sales for foreign buyers when US prices exceed prevailing world prices for targeted dairy products and destinations. As part of its World Trade Organization commitments resulting from the Uruguay Round Agreement on Agriculture, annual export subsidy ceilings are set for each commodity. These define a maximum quantities and a maximum budgetary expenditures, which is charged against the US in the calculation of allowable but constrained subsidies under the WTO agreement. All sales under the DEIP are made by the private sector, not the U.S. government.

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An invitation for offers issued by USDA may be one of two types: those inviting exporters to submit a competitive offer for a bonus, and those inviting exporters to apply for an announced bonus. Once an invitation for offers is issued, it is up to agricultural exporters to contact prospective buyers in eligible countries and negotiate a sales contract covering price, quantity, quality, delivery, and other terms. The sale may be contingent on USDA's approval of a bonus. Each prospective exporter submits an offer to USDA requesting a bonus that would allow the sale to take place at the agreed price.

Under an invitation for competitive offers, USDA reviews all bids for the competitiveness of the bonus value requested and compares the bids with offers from other U.S. exporters and with sales of competitor countries. Under an announced bonus, compliant offers meeting all program requirements are accepted on a first-come, first-served basis. USDA has the right to reject any or all bids.

Once USDA accepts a bid, the exporter and USDA's Commodity Credit Corporation (CCC) enter into an agreement. The bonus is paid to the U.S. exporter in cash. The CCC determines the bonus payment by multiplying the bonus specified in the agreement by the net quantity of the commodity exported. Once an exporter furnishes USDA with evidence that the specified commodity has been exported to the target destination under the terms of the agreement, the exporter can request payment of the bonus.

In implementing the program, USDA has taken the position that in order for use of DEIP to be justified under the Uruguay Round agreement, US prices should be above prices in international markets and the claim that we

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are countervailing other countries' subsidies should be plausible. In recent years, US and "world" prices have been closely aligned for the basic dairy commodities, such as nonfat dry milk; hence, the economic and legal justification for an export subsidy has been weak. Moreover, the EU has seriously reduced its very high level of dairy export subsidies as part of its own agricultural policy reform in the last few years, thereby diminishing the countervailing argument. The EU did resume export subsidies following price supporting actions it took in response to 2009, but its longer term commitment to dismantling dairy industry support programs is genuine and continuing.

While DEIP is the program designed specifically to enable dairy product exports, FAS has a number of programs that are intended to enable or assist US agricultural and food exporters. These range from export promotion activities (such as trade shows and more personal tours and visits) to programs that facilitate commercial transactions. An export credit guarantee for commercial financing of U.S. agricultural exports is a valuable tool used by many agricultural industries. These Commodity Credit Corporation programs provide a credit guarantee to a foreign bank to whom the foreign buyer has applied for a letter of credit or similar instrument and for which the funds will be used to buy agricultural or food products subject to a privately negotiated contract that is otherwise completed.

Given the restrictions on DEIP authorization caused by the requirement for U.S. prices to be above world prices and/or the necessity to substantiate

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other countries' subsidies, it is unlikely that DEIP could be used as countercyclical assistance.

Risk Management Programs

Risk management programs are available to farmers through both the private and public sectors. Hedging either milk or input prices (typically feed) is something farmers can do at any time without any government involvement. In addition, dairy cooperatives and other buyers can offer farmers forward contracts involving some kind of milk price guarantee over a period of time. Typically such contracts are backed up by future hedging positions taken by the buyer. While hedging has been available for dairy farmers to use for a number of years, the number of farmers or percentage of the US milk supply that takes advantage of these tools appears to be small.

There are some concerns that limit the use of risk management tools. Futures contracts tend to be "lumpy" - they are offered in unit sizes that are not easy for small producers to use. Hedging is an unfamiliar concept to many dairy farmers, such that many find the concept and its implementation to be confusing and thus risky. While markets are moving toward the maturity of any contract month, buyers or sellers may find themselves vulnerable to margin calls that require them to post earnest money to cover their position when the market turns in the opposite direction. This can be an expensive proposition for a dairy farmer.

USDA's Risk Management Agency (RMA) offers two risk management tools that offer farmers price or margin protections that address either the cost issue or the "lumpy" bundling issues that tend to limit the use of purely

private sector tools. One is designed specifically for dairy farmers and is called Livestock Gross Margin - Dairy, or LGM-Dairy. Another is a program available for any type of farm called Adjusted Gross Revenue Lite or AGR-Lite.

Livestock Gross Margin (LGM) Dairy

The original LGM products were created for cattle and swine growers. In 2007, this concept was adapted to milk producers and a similar product was gradually made available on a state-by-state basis.

LGM-Dairy is a bundled hedging tool that provides protection to dairy producers when feed costs rise or milk prices drop. Unlike dairy price or corn price risk management using regular hedging tools, LGM-Dairy establishes a floor on Gross Margins and pays an indemnity if the farmer's results are less than expected. The farmer chooses how much of the farm's milk to cover and the time period of the coverage (when and how long). Premiums are based on expected milk revenue and expected feed costs that are calculated using futures market prices on Class III milk, corn and soybean meal at the time the insurance is purchased. An indemnity benefit is paid to farmers at the time the futures markets settle for a given month. The settlement prices determine the "actual" margin, not the prices an individual farmer actually receives or pays. The idea is that any given farmer's milk revenue or feed costs will not equal the futures prices on the Chicago Mercantile Exchange, but they will sufficiently parallel the CME prices to make the difference on the futures market a relevant indicator of the difference a farmer actually experiences over time

There is no minimum amount of milk needed (unlike a futures contract) but there is a maximum of 24 million pounds per ten-month crop year. Producers may sign up for this program monthly and may choose to cover up to ten months of production at a time.

Farmers pay a premium for this margin insurance. Premiums are calculated using a complex system that attempts to measure the likelihood of an indemnity payment at the time a farmer purchases the insurance. Not unlike buying typical insurance against a peril like flooding or fire, the original idea was that farmers would pay the expected actual cost of the margin protection. Any money paid to farmers would have to come from the premiums all farmers paid over time.

Recently RMA announced several changes to how they would administer LGM-Dairy. These changes were largely patterned after proposals the National Milk Producers Federation have made for a new insurance product called Dairy Producer Margin Protection Plan. The new LGM-Dairy uses a different procedure for calculating milk returns over feed costs and perhaps most significantly provides a subsidy to lower the premium costs for farmers.

Adjusted Gross Revenue Lite (AGR Lite)

In 200x, RMA developed a new insurance product that it intended for all farmers and that would be based on adjusted gross income as reported on Schedule F of the farm business's taxes. The concept was to combine protection both from production losses related

to natural causes and from output price declines or input price increases related to market fluctuations. The product became quite complex and was difficult to use. AGR-Lite was developed in 200x to provide a simpler tool that would have the same goal.

Any farmer can use AGR-Lite and the revenue protection applies to the whole farm not one product. Premiums are lower for farmers who sell more products, just as their price risk is reduced by that diversity.

Producers cannot participate if:

If more than 35% of the income is from animals and animal products.

The maximum amount of milk you can market is 1.6 million pounds.

The program does not count feed that is grown only the feed that is purchased.

Farm liability cannot exceed $1 million

Gross income must be below $2,051,282

Farmers select the percentage of their total adjusted gross income they will cover and the percentage of the difference that they can receive if their actual AGI is less than the income coverage that was determined for them. The maximum income coverage is based on each producer's average AGI over the previous five years.

Use and Participation in LGM-Dairy and AGR-Lite

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Although they are clearly similar, there are several differences between the LGM-Dairy and AGR-Lite approaches to income protection, apart from the fact that one is tailored to dairy and other is designed for whole farms. LGM-Dairy works on the basis of a price spread, the difference between the price of milk and the prices of feed expressed relative to an amount of milk produced. The resulting margin is expressed in $/cwt. AGR-Lite is based on the concept of income less production expenses, where both vary with the amount of milk produced (and other agricultural sales) and the amount of feed (and other production inputs) purchased. Adjusted gross income is not affected only by the prices of outputs and inputs. Total sales can be positively or negatively affected by changes in marketings. Total expenses can likewise be positively or negatively affected by changes in the amounts of inputs purchased. These subtly different concepts can have real differences in the impact on or payments to farmers. As such, they provide lessons in thinking about alternative or modified policies for dairy farmers.

Under their current design, there has been very little participation on the dairy side throughout the United States in either of these programs. There are several reasons for this lack of participation:

1. Size limits
2. Market conditions
3. Who it is designed for
4. Lack of return on investment

Members of Congress have requested that USDA join these two programs together and make them more producer friendly. Congress wants this program to be more for small beginning farmers rather than the average dairy producer in the United States.

CCC Charter Act, Section 5

The Commodity Credit Corporation (CCC) is a Government-owned and operated entity that was created in 1933 to handle commercial transactions that involve agricultural commodities. It is used in various programs that exist to stabilize, support, and protect farm income and prices. CCC also facilitates the movement of surplus or other agricultural commodities to various government and non-governmental outlets.

The CCC was formally (re)chartered in 1948 under the Commodity Credit Corporation Charter Act. This legislation establishes the general purpose of the CCC and it general operating rules and authorities. Section 5 of the Act is excerpted below. In this section, various authorities are granted that relate to the acquisition and disbursement of agricultural commodities.

SEC. 5. [15 U.S.C. 714]

SPECIFIC POWERS.—In the fulfillment of its purposes and in carrying out its annual budget programs submitted to and approved by the Congress pursuant to Chapter 91 of Title 31, the Corporation is authorized to use its general powers only to —

Support the prices of agricultural commodities (other than tobacco) through loans, purchases, payments, and other operations.

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(b) Make available materials and facilities required in connection with the production and marketing of agricultural commodities (other than tobacco).

(c) Procure agricultural commodities (other than tobacco) for sale to other Government agencies, foreign governments, and domestic, foreign, or international relief or rehabilitation agencies, and to meet domestic requirements.

(d) Remove and dispose of or aid in the removal or disposition of surplus agricultural commodities (other than tobacco).

(e) Increase the domestic consumption of agricultural commodities (other than tobacco) by expanding or aiding in the expansion of domestic markets or by developing or aiding in the development of new and additional markets, marketing facilities, and uses for such commodities.

(f) Export or cause to be exported, or aid in the development of foreign markets for, agricultural commodities (other than tobacco) (including fish and fish products, without regard to whether such fish are harvested in aquacultural operations).

(g) Carry out conservation or environmental programs authorized by law.

Carry out such other operations as the Congress may specifically authorize or provide for.

In the Corporation's purchasing and selling operations with respect to agricultural commodities (other than tobacco) (except sales to other Government agencies), and in the warehousing, transporting, processing, or handling of agricultural commodities (other than

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tobacco), the Corporation shall, to the maximum extent practicable consistent with the fulfillment of the Corporations purposes and the effective and efficient conduct of its business, utilize the usual and customary channels, facilities, and arrangements of trade and commerce (including, at the option of the Corporation, the use of private sector entities).

This Section of the legislation defines a number of things that the CCC may do; however, this is a good deal different from actually being able to do, or being required to do, something. It is under these general authorities that the Secretary is able to implement the procurement and sale of dairy products under the DPPSP and various other programs related to domestic and international food assistance. It is in the legal and financial authorizations of these other programs that CCC is specifically enabled to, say, buy a load of 600 pound barrel cheese, have it converted to 5 pound loaves of processed cheese, and then distribute the processed cheese to schools, prisons, or a food provider in a less developed country.

If there is no specific program that requires the Secretary to procure and/or distribute dairy or other commodities, he could use the provisions of this Charter to do so under his discretion if and only if there is a source of funds to do so. Permission to spend money in this fashion must be given by the President's Office of Management and Budget (OMB), which is described and discussed in a later section.

This program does offer the Secretary some flexibility in application and is addressed further as a recommendation.

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Domestic Food Assistance Programs

The single largest share, indeed the majority, of the budget of the US Department of Agriculture, about two-thirds, is devoted to food and nutrition programs. These programs are generally administered through the Food and Nutrition Service and include the following:

1. Supplemental Nutrition Assistance Program (SNAP, formerly Food Stamps)
2. Women, Infants, and Children (WIC)
3. School Meals
    a. National School Lunch
    b. Fresh Fruit and Vegetable Program
    c. School Breakfast Program
    d. Special Milk Program
    e. Team Nutrition
4. Summer Food Service Program
5. Child and Adult Care Food Program
6. Food Assistance for Disaster Relief
7. Food Distribution
    a. Schools/Child Nutrition Commodity Programs (CNP)
    b. Food Distribution Program on Indian Reservations
    c. Nutrition Services Incentive Programs (CNP)
    d. The Commodity Supplemental Food Program (CSFP)
    e. The Emergency Food Assistance Program (TEFAP)

Each of these programs is described at the FNS website, among other sources (http://www.fns.usda.gov/fns/). Obviously, all of these programs but one are not exclusive to milk and dairy products, but many of these programs have played a very important role in increasing the availability and use of dairy products among children and needy people.

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The Special Milk Program provides cash subsidies to schools for milk they serve to children not covered under the School Lunch and similar programs.

USDA provides grants to States, which in turn have primary responsibility for delivering WIC program benefits to pregnant women, women with young children and those infants and young children. Historically, WIC has had a strong emphasis on providing milk and other nutritious dairy products to this very important target group.

TEFAP was originally started during the early 1980s when surpluses under the DPSP became enormous. Many elderly and other needy US citizens benefitted from donations of surplus cheese and butter. The success of the Temporary Emergency Food Assistance Program led to the creation of The Emergency Food Assistance Program. Today, TEFAP is the primary vehicle for distributing commodity foods to States, that in turn distribute food to Food Banks and similar local food distribution agencies.

Each of these programs can be a vehicle for the use and distribution of dairy foods. Virtually all have done so in the past, some to a very significant degree. However, two key factors limit their effectiveness as a short term response to a dairy surplus.

First, these programs are budgeted. They have a certain amount of funding that is controlled by Congressional appropriations and/or more discretionary decisions of OMB. USDA may be able to shift some funding around but it can't make the pie bigger. Even shifting money is difficult if

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not practically impossible as there are always numerous legitimate claims on available funds.

Second, these programs involve and require considerable time for planning, implementation, and execution. Programs that coordinate with State run activities, dovetail into State planning and timing and ultimately the distribution and use of food or food subsidies is subject to some discretion by the receiving State. Programs in which USDA works directly with an agency typically involve a spending and utilization plan of that agency. Schools, in particular, plan their budgets early in the calendar for implementation in the coming school year that starts in August or September. Once in place, it is difficult to impossible to change these plans.

Congress can certainly create funding and programs to respond to something like the dairy crisis of 2009, but once funding for food and nutrition programs are established it is next to impossible for the Secretary to alter the plan or find additional funding to support one agricultural or food sector.

Section 32, Public Law 74-320

In 1935, as part of its response to the hardship for agriculture during the Great Depression, Congress created a permanent authority to give USDA money from U.S. customs receipts (tarriffs) to support farmers whose products were not otherwise covered or protected by more specific commodity policy. The so-called Section 32 funds conderable and the Secretary has a lot of discretion in how they are used. The following is from a Congressional Research Service report written in 2006.

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Section 32 of the act of August 24, 1935, authorizes a permanent appropriation equal to 30% of annual U.S. customs receipts (P.L. 74-320 as amended; 7 U.S.C. 612c). This money was first available to assist Depression-era producers of non-price-supported commodities. Section 32 funds, along with up to $500 million in any unobligated prior year funds, are to be used for (1) encouraging the export of farm products through producer payments or other means; (2) encouraging the domestic consumption of farm products by diverting surpluses from normal channels or increasing their use by low income groups; and (3) reestablishing farmers' purchasing power. The Secretary of Agriculture has considerable discretion in deciding how to achieve these broad objectives.

.....Today [viz. 2006], most of this appropriation (now approximately $6.5 billion yearly) is transferred to the U.S. Department of Agriculture (USDA) account that funds child nutrition programs. Other Section 32 funds are used by USDA to purchase meats, poultry, fruits, vegetables, and fish, which are diverted mainly to school lunch and other domestic food programs. Several times in recent years, the Secretary of Agriculture also has drawn substantial amounts from Section 32 to pay for special farm disaster relief. This has added to the debate over how much flexibility the Secretary should have over use of the reserve, and whether the disaster aid has or could come at the expense of the other Section 32 activities.

Excerpted from:

Farm and Food Support Under USDA's Section 32 Program

by Geoffrey S. Becker, Specialist in Agricultural Policy

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Resources, Science, and Industry Division

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Inasmuch as there is a Dairy Price Support Program and a Milk Income Loss Contract that are obviously specifically for the dairy sector, in the past it has been determined that Section 32 funds could not be used to purchase or distribute dairy products because milk is an otherwise supported commodity. With the DPSP haveing been modified as the DPPSP in 2008, there is an argument that government support has been legally restricted to commodity packaged butter, nonfat dry milk, and cheddar cheese. Under this narrow interpretation, there may be a legal possibility of using Section 32 funds for other dairy products, such as mozzarella cheese, fluid milk, or whey protein concentrate.

Section 32 does not create a program, it creates a fund of money. Thus, this money can be used in conjunction with existing programs that are designed for domestic food assistance or international exports or food aid. The legislative language "reestablishing farmer's purchasing power" suggest an even broader authority to, for example, supplement a countercyclical payment to dairy farmers.

The flexibility of Section 32 and the amount of funding available are alluring. What remains unclear is whether legally or, perhaps more importantly, politically, it is possible to use Section 32 funds to benefit the

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dairy sector, simply because there are other programs specifically designed for dairy.

Given sufficient funding, food assistance programs do provide the Secretary some latitude in execution that could improve dairy farm revenue because of increased dairy product demand caused by these programs. This category of assistance is addressed in the recommendations outlined later in this document.

International Food Assistance Programs

There are a number of programs that have been designed to provide food to needy people in low income countries on an ongoing or emergency basis or to provide emergency assistance in a time of natural or other specific disaster. These include:

A. Food for Peace
B. McGovern-Dole
C. Food for Progress
D. Section 416(b)

The granddaddy of all international food assistance programs is Food for Peace. This program was first authorized under the Agricultural Trade Development and Assistance Act of 1954, at a time of agricultural surpluses. At first considered a temporary response to deal with agricultural surpluses, this program has evolved to become an icon of US food assistance, considered a core program by advocates for low income countries. Using the section of the law in which this Act was codified, the program was routinely referred to as Public Law 480 or P.L. 480. Today it is called by the

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legislation which defines its current parameters - The Food for Peace Act. The FPA has three titles, and each title has a specific objective and provides assistance to countries at a particular level of economic development. Title I is administered by USDA. Titles II and III are administered by USAID - the U.S. Agency for International Development. USAID is an independent federal agency that operates under the supervision of the Secretary of State.

http://www.fas.usda.gov/excredits/FoodAid/pl480/pl480.asp

FPA, Title I–Trade and Development Assistance, provides for government-to-government sales of U.S. agricultural commodities to developing countries on credit or grant terms. Agreements under the Title I credit program may provide for repayment terms of up to 30 years with a grace period of up to 5 years. The authority also allows for grant programs, which have outnumbered loans in recent years. Depending on the agreement, commodities provided under the program may be sold in the recipient country and the proceeds used to support agricultural, economic, or infrastructure development projects.

Since fiscal year 2006, new funding has not been requested because demand for food assistance using credit financing has fallen or grant programs have been a more appropriate tool.

FPA, Title II–Emergency and Private Assistance, provides for the donation of U.S. agricultural commodities to meet emergency and non-emergency food needs in other countries, including support for food security goals.

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FPA, Title III–Food for Development, provides for government-to-government grants to support long-term growth in the least developed countries. Donated commodities are sold in the recipient country, and the revenue generated is used to support economic development programs. In recent years, this title has been inactive.

Although the Secretary of Agriculture is responsible for Title I uses of agricultural commodities, he can't do much of the program is not funded. In recent years, advocates for international food assistance have strongly urged that Congress convert any support for using US grown and exported food in needy countries to direct cash subsidies that would allow foreign governments or approved agencies in foreign countries to buy food wherever they can find it most cheaply. It is argued that this approach would provide the most food assistance bang for the buck, but of course this would not provide much support for US agriculture.

The McGovern-Dole International Food for Education and Child Nutrition Program helps promote education, child development, and food security for some of the world's poorest children. It provides for donations of U.S. agricultural products, as well as financial and technical assistance, for school feeding and maternal and child nutrition projects in low-income countries. The program was authorized by the Farm Security and Rural Investment Act of 2002 and is administered by the Foreign Agricultural Service.

The commodities are made available for donation through agreements with private voluntary organizations (aka, PVO or NGO, for non-governmental organizations), cooperatives, intergovernmental organizations,

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and foreign governments. Commodities may be donated for direct feeding or, in limited situations, for local sale to generate proceeds to support school feeding and nutrition projects.

Under the Food for Progress Act of 1985, agricultural commodities are provided to developing countries and emerging democracies committed to introducing and expanding free enterprise in the agricultural sector. Commodities are currently provided on a donation basis to foreign governments, private voluntary organizations, nonprofit organizations, cooperatives, or intergovernmental organizations.

The implementing organizations request commodities and USDA buys those commodities from the U.S. market. USDA donates the commodities to the implementing organizations and pays for the freight to move the commodity to the recipient country.

The Section 416(b) program is authorized by the Agricultural Act of 1949, as amended. This program provides for overseas donations of surplus commodities acquired by the Commodity Credit Corporation (CCC). Donations may not reduce the amounts of commodities that are traditionally donated to U.S. domestic feeding programs or agencies, and may not disrupt normal commercial sales.

Availability of commodities under Section 416(b) depends on CCC inventories and acquisitions, and programming varies from year to year. The commodities are made available for donation through agreements with foreign governments, PVOs, cooperatives, and intergovernmental organizations. Depending on the agreement, the commodities donated under

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Section 416(b) may be sold in the recipient country and the proceeds used to support agricultural, economic, or infrastructure development programs.

The Section 416(b) program is currently not active, as there are no CCC-owned commodities available at this time.

Farm Loan Programs

FSA makes direct and guaranteed farm ownership (FO) and operating loans (OL) to family-size farmers and ranchers who cannot obtain commercial credit from a bank, Farm Credit System institution, or other lender. FSA loans can be used to purchase land, livestock, equipment, feed, seed, and supplies. Loans can also be used to construct buildings or make farm improvements. FSA employs farm loan officers who originate and service Direct Farm Ownership and Operating Loans. FSA works with banks and Farm Credit System institutions, providing guarantees on loans originated and serviced by those commercial lenders. FSA operates by the authority of the Consolidated Farm and Rural Development Act (7 U.S.C. 1936) and is administered by USDA's Farm Service Agency.

The USDA-FSA Farm Loan Program (FLP) is an important source of credit to dairy producers. FLP provides direct loans, guarantees on loans originated through commercial banks or Farm Credit System associations, and interest assistance on operating lines of credit, as well as emergency loans in situations where farmers have been adversely impacted by severe weather conditions. FLP targets a significant portion of its funds to beginning farmers: 50% of Direct Operating, 40% of Guaranteed Operating, 75% of Direct Farm Ownership, and 40% of Guaranteed Farm Ownership. In

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addition to targeting funds towards beginning farmers, each state FSA FLP targets a percentage of their loan funds to Socially Disadvantaged Farmers based on state demographics.

In federal fiscal year 2010, $6.115 billion was appropriated for FLP. As of September 3, 2010 the FLP had in its national portfolio 33,541 loans for a total of $4.913 billion. The maximum principal amount per borrower under the direct loan programs is $300,000. The maximum total principal amount for direct loans plus loan guarantees is $1,119,000 (This amount is adjusted annually based on inflation.)

Approximately 52% of the loans in the FLP portfolio were Direct Operating Loans typically used for purchase of cattle, machinery, building construction, or other farm improvements. An additional 20% were Guaranteed Operating Loans originated and serviced by commercial lenders. Direct Farm Ownership Loans and Guaranteed Farm Ownership Loans used for purchase of farm real estate each accounted for 12% of the loans in the portfolio.

The top five states in FFY 2009-10 in terms of number of new loan applications (new direct and guarantee loan volumes for the first eleven months of the fiscal year are in parenthesis):

1. Wisconsin ($419 million)
2. Minnesota ($309 million)
3. Iowa ($286 million)
4. Texas ($220 million)
5. Nebraska ($235 million)

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Wisconsin FSA FLP Example

As Wisconsin is the largest customer of the Farm Loan Program, with by far the majority of its loans procured by dairy producers, we provide here a closer look at Wisconsin's successful use of the program.

The Wisconsin FSA FLP portfolio crossed the $1 billion threshold in early 2010. As of August 31, 2010 it held 4,956 loans for a total of $1.24 billion. Of these, 62% were direct loans and 38% were loan guarantees. Approximately 90% of FLP borrowers in Wisconsin are dairy producers.

The FSA FLP has, for many years, been an important source of credit for Wisconsin dairy producers. Wisconsin FSA FLP has historically been one of the top three among all states in both the number and the dollar volume of loans. FSA FLP has loan program managers assigned to cover every county in the state. They do an excellent job of outreach to farmers. They partner with many other entities that can help them more effectively serve farmers including the Wisconsin Department of Agriculture, Trade and Consumer Protection, Wisconsin Technical College System, University of Wisconsin School for Beginning Dairy and Livestock Farmers, and others. FSA has developed strong working relationships with commercial agricultural lenders to broaden the scope of its loan guarantee and interest assistance programs. In short, there are few ag borrowers or lenders in Wisconsin that are not aware of the FSA FLP.

As commercial agricultural credit became more difficult to obtain in 2009, the importance of the Wisconsin FSA FLP became even more pronounced.

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Lenders pointed many borrowers towards the FLP, and FLP loan volume in the state soared.

There are some key reasons that the FSA FLP works so well in Wisconsin.

Wisconsin FLP has a high participation in the Preferred Lender Program (PLP) which allows experienced agricultural lenders to quickly obtain USDA Loan Guarantees with a minimal amount of paperwork. Subsequent review by state FSA FLP staff allows the private lender to conduct their business with minimal disruption of their normal operating procedures. FSA FLP monitors the aggregate performance of each lender rather than each individual loan application. Lenders with strong records of success maintain PLP status; those with higher losses are more closely scrutinized. (Many states have struggled to implement these loan guarantee processes.)

Wisconsin FSA FLP views itself as a partner with private agricultural lenders, and the lenders look at FSA FLP in that way as well. In many cases, the private lender has part of the financing package and FSA has part of the financing package. It is not an "either or" situation.

Wisconsin FSA FLP contracts out to the private sector for many services such as real estate and chattel appraisals that assist their loan officers, which allows them to focus on the duties that only they can do. In the past, FSA FLP loan officers would have done these tasks. By contracting out for these services, FSA FLP has freed up its loan officers to serve new loan applicants and service their existing loan

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portfolios. This has allowed Wisconsin FSA FLP to be a national leader in loan-making, while keeping delinquencies and losses among the lowest in the nation. Wisconsin FSA FLP has centralized its loan liquidation process in the state office, which also frees up field loan staff to make and service more loans.

Despite maintaining a large loan portfolio with borrowers who were unable to obtain commercial credit, Wisconsin FSA FLP has experienced relatively low delinquency rates. In the 2009-2010 FFY, approximately 1.93% of the direct loan portfolio and 0.88% of the guaranteed loan portfolio was delinquent. By commercial lending standards, these delinquency rates are relatively low, particularly considering the poor economic conditions in the dairy industry during the period.

On a national level, Secretary Vilsack issued a letter at the height of the 2009 dairy crisis to all of FSA's dairy producer-borrowers informing them of the loan servicing options available to alleviate financial stress. These options included lifting milk check assignments to allow money to flow through for family living and operating expenses, deferral of principal and interest payments, lowering payments through rescheduling or re-amortizing of debt, and other options. Many FLP borrowers contacted their loan managers to take advantage of the relief that was available.

It is apparent that certain geographies have leveraged the Farm Loan Programs more effectively than others. We recommend that FSA examine why these disparities exist and develop strategies to share best practices across regions.

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Market News, Research, and Promotion Programs

Numerous programs exist to support dairy market developlment, day-to-day dairy business decisions, and the ability of dairy businesses to plan. They do so by providing information on milk and dairy product prices, market conditions, and the market outlook. Such programs include the AMS Dairy Market News, various data serials published by NASS, ERS, and FAS, special analytical reports by ERS and WASDE. USDA also has certain programs for market and business development and AMS participates in the oversight of the National Dairy Promotion and Research Board.

These programs typically provide valuable information for buyers and sellers in dairy markets. While useful in the long term, they are not programs that can be easily utilized for short term effects or benefits.

The Office of Management and Budget

The Secretary of Agriculture can only initiate and operate programs 1) which he is authorized to administer and 2) which have a well-defined mandatory or discretionary source of funding. If the program is mandatory, Congress provides authority to spend whatever money is required to achieve the purposes of the Act. If the program is discretionary, Congress may or may not provide funding to support the program. When funding is limited, which of course is the general rule, the Office of Management and Budget plays a crucial role in determining what can and what may be done.

The following is excerpted from the website of the President's Office of Management and Budget. It describes the structure and role of the OMB.

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The Mission and Structure of the Office of Management and Budget

The core mission of OMB is to serve the President of the United States in implementing his vision across the Executive Branch. OMB is the largest component of the Executive Office of the President. It reports directly to the President and helps a wide range of executive departments and agencies across the Federal Government to implement the commitments and priorities of the President.

As the implementation and enforcement arm of Presidential policy government-wide, OMB carries out its mission through five critical processes that are essential to the President's ability to plan and implement his priorities across the Executive Branch:

Budget development and execution, a significant government-wide process managed from the Executive Office of the President and a mechanism by which a President implements decisions, policies, priorities, and actions in all areas (from economic recovery to health care to energy policy to national security);

Management — oversight of agency performance, Federal procurement, financial management, and information/IT (including paperwork reduction, privacy, and security);

Coordination and review of all significant Federal regulations by executive agencies, to reflect Presidential priorities and to ensure that economic and other impacts are assessed as part of regulatory decision-making, along with review and assessment of information collection requests;

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Legislative clearance and coordination (review and clearance of all agency communications with Congress, including testimony and draft bills) to ensure consistency of agency legislative views and proposals with Presidential policy; and

Executive Orders and Presidential Memoranda to agency heads and officials, the mechanisms by which the President directs specific government-wide actions by Executive Branch officials.

http://www.whitehouse.gov/omb/organization_mission/

OMB has significant influence on the spending ability of any federal agency, including USDA and the Secretary of Agriculture. When Congress has provided a clear mandate and sufficient funding to conduct a program, OMB's only concern is the efficient execution of the required program. However, when an authorized program is unfunded or underfunded the Secretary must work with OMB to determine where funding might be available or even whether any such funding can be found. Inasmuch as OMB reports to the President, its priorities, both programmatically and from the standpoint of financial stewardship, are driven by the President's overarching priorities. In periods when budgets are tight, OMB tows a hard line on discretionary spending. Even when budgets have some slack, OMB will and must evaluate tradeoffs when an Executive agency, like USDA, makes a request. Needless to say, when there is some slack in the budget, this is well known. Demand always exceeds supply in the world of the US budget.

In Conclusion

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The essence of this review and report is that there are numerous programs which could or have been used to benefit dairy farmers and the dairy sector in times of stress. This include programs to directly support prices or farm incomes and programs that more indirectly affect the demand for dairy products and thereby strengthen markets and prices. At present, there are no programs to reduce supply and achieve price benefits from that perspective.

In theory, all of these programs could be extremely helpful in times of economic stress, but in practice, these programs are not well suited to unanticipated stress and quick responses to emergency conditions. In many cases, the Secretary of Agriculture has no authority to change a program or operate it outside of a very narrow range of legislatively defined parameters. In some cases, the law grants the Secretary some discretion in defining a program's parameters, but when the Secretary's decisions have an impact on government expenditures, even a Secretary must get approval from the President's Office of Management and Budget. Since its creation in 1922, this office has played the role of budget watchdog. While the specific economic policies and priorities of Presidents certainly change over time, OMB's job is to carefully and cautiously steward the resources Congress provides to the Executive Branch. There are many competing demands for many worthy needs. Obtaining permission to use discretionary authority for agricultural programs in general and dairy in particular can prove difficult.

Recommendations for the Use of Existing Programs

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Barring legislative changes, the only two programs that permit the Secretary some flexibility in their application are the Dairy Product Price Support Program and one or more food assistance programs. If the Secretary can identify sources of money, it would be possible for him to stimulate demand and thereby lift prices via either of these approaches.

When dairy farm margins decrease to a level that cause concern over the production sector's sustainability, we suggest that the Secretary guide food assistance purchases toward dairy product procurement. If dairy farm margin levels decrease to extreme distress levels as seen in 2009, the Secretary can increase the levels of DPPSP to prices which provide more revenue support for dairy farmers.

In the case of TEFAP, School Lunch and the like, additional funding could be used to simply do more of what each program is designed to do. USDA would be creating a kind of new demand for dairy products which would have a competitive effect on market prices when the market is soft. The Secretary should ensure that government purchased dairy foods donations do not simply displace commercial sales. Dairy foods should be provided to people who would not otherwise purchase them. The distinguishing characteristic of food assistance is that USDA is enabling the competitive purchase of dairy foods that users in these food assistance programs want and the pricing is competitive around a product specification that is consistent with users' needs.

In the case of the DPPSP, the extra "demand" comes in the form of government purchases that aim to move cheese, butter, and/or nonfat dry milk off of the commercial market. Typically, any such product so acquired

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will either be sold back into commercial markets at the sellback price or will be made available for use in a food assistance program (possibly under Sec. 416(b) or one of the domestic programs, such as TEFAP or School Lunch). Under the DPPSP, USDA buys a limited type of bulk dairy commodity at a fixed price and then tries to find a good or least-loss use for it.

As a general rule, the DPPSP approach is likely to be able to buy more milk equivalent amounts but using the products to a good purpose is more difficult. The supplemental funding for a food assistance purpose has the flip side effect. It would likely result in less milk equivalent sales for a given amount, but the product would more likely be put to good use for groups that had been previously identified as needy and deserving of assistance. Because of the negative implications of movements of the DPPSP prices on commodity financial markets and the financial positions of farmers and others who have chosen to mitigate risk through those markets, we suggest prioritizing food assistance programs over increase DPPSP levels.

The Secretary should use extreme care by applying both of these approaches judiciously and rarely. If these approaches are used too frequently, they lose their ability to be a countercyclical offset. The application of these programs can be either discretionary or triggered by quantitative measurements. The advantage of being totally discretionary is that the Secretary and his advisers can take into account a full range of market issues and policy objectives. The advantage of a trigger is that the industry has more certainty about when or under what conditions something will happen. The trigger approach has the benefit of reducing market risk.

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We suggest that USDA implement the trigger approach. We recommend using the methodology of Milk Income over Feed Cost measure (methodology defined here) as a trigger for a countercyclical intervention. Within this framework, the first trigger (specify level) will indicate a demand program be used. At the second trigger (specify level), the DPPSP should be raised by xx.

In no way do we intend to indicate that the Committee supports continuation of the DPPSP. We merely intend to provide a framework around which the existing authority should be applied.

Comments on Possible Unintended Consequences

One of the inherent challenges in any public policy is that there are few choices that make everyone better off. The political and policy worlds necessarily involve tradeoffs, which exist in the dairy sector among producers and among dairy processors, retailers, consumers, taxpayers, and alternative agricultural or food sectors. This committee has been charged with addressing dairy farm profitability and milk price volatility. This puts the focus on the farm sector, but downstream effects constrain any dairy policy debate. Even those policies which are good for some dairy farmers are not good for all dairy farmers.

The specific topics of dairy farm profitability and milk price volatility continue to be studied by the DIAC. The recommendations presented here are framed from the perspective of the DIAC charge. We recognize that the Secretary has a responsibility to balance and represent a public interest in the administration of USDA programs and acknowledge that achieving that

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balance is a difficult task. Programs aimed at assisting farmers by improving their price can be viewed as constraining sales, being contrary to the interests of consumers and, in fact, even contrary to the interest of some dairy farmers. The purpose of the policies discussed here is counter excessive market conditions, but not to eliminate fundamental market functions.

A Caveat About Future Conditions and the "Black Swan"

The purpose of the report is to reflect on the usefulness of existing programs in dealing with recent and current challenges in dairy markets related to dairy farm profitability and milk price volatility. It is reasonable, indeed advisable, to ask whether this is just a lesson in history or whether we expect that there will be a next time when current programs could be deployed more effectively.

In 2007, Dr. Nassim Taleb, who holds a PhD in management science fromt the University of Paris, published his book The Black Swan. The book and the ideas it expresses have been much discussed of late and seems to have particular relevance to the economic conditions of 2009. Dr. Taleb's central tenet and contribution is that rare events (like seeing a black swan) have a disproportionate large impact, potentially either postive or negative, on human decisions and outcomes. In a sense, we overreact to extreme events. A lesser discussed element of Dr. Taleb's essay is his contention that in the face of unexpected and extreme events, which by definition challenge our ability to comprehend and explain them, we have a tendency

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to concoct new explanations that are hard to rigorously test. This often leads to a situation where we risk fitting the facts to the story.

It is well to consider how likely the conditions of 2009 are to be repeated. Are these the equivalent of the 20-year flood event, 50-year, 100-year, 500-year? It is hard, if not impossible, to answer that question. In the end, we may have to risk Dr. Taleb's prediction and just take our best guess, but it is wise to pause and consider whether we run the risk of creating costly solutions to problems that are unlikely to be repeated soon enough to justify the cost. At some point, engineers and policy-makers have to ask the question, when is the dike big enough and when do we say if the water goes over this dike, we'll just have to make sure our warning system is good enough to get people out and our response system good enough to help them rebuild.

In evaluating current or alternative dairy policies, or any economic policy, we face a similar challenge.

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